5

No. 87-453

In The

Supreme Court of the United States

October Term, 1987

AMERADA HESS CORPORATION, *et al.*,

Appellants,

v.

DIRECTOR, DIVISION OF TAXATION,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF NEW JERSEY

MOTION OF APPELLEE TO DISMISS OR AFFIRM

W. CARY EDWARDS
Attorney General of New Jersey
Attorney for Appellee
Division of Law
Hughes Justice Complex
CN 112
Trenton, New Jersey 08625
(609) 292-1526

JAMES J. CIANCIA
Assistant Attorney General
Of Counsel

MARY R. HAMILL
Deputy Attorney General
Counsel of Record and
On the Brief

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
or call collect (402) 342-2831

QUESTION PRESENTED

Whether the Due Process, Commerce or Equal Protection Clause of the United States Constitution prevents New Jersey from denying a deduction under its corporate franchise tax for the federal crude oil windfall profit tax.

TABLE OF CONTENTS

Page

COUNTERSTATEMENT 1

ARGUMENT:

POINT I:

PLENARY REVIEW IS NOT WARRANTED BECAUSE THE QUESTION IS NOT SUBSTANTIAL 9

POINT II:

PLENARY REVIEW IS NOT WARRANTED BECAUSE THE SUPREME COURT OF NEW JERSEY CORRECTLY REJECTED APPELLANTS' CLAIMS THAT DENIAL OF A DEDUCTION FOR THE WINDFALL PROFIT TAX IMPOSES NEW JERSEY'S CORPORATION BUSINESS TAX ON EXTRATERRITORIAL VALUES AND DISCRIMINATES AGAINST INTERSTATE COMMERCE 16

CONCLUSION 24

APPENDIX—Statute Involved 1a

TABLE OF AUTHORITIES

Page

CASES

Boston Stock Exchange v. State Tax Commission, 429 *U.S.* 318 (1977) 20

Commonwealth Edison Co. v. Montana, 453 *U.S.* 609 (1981) 21, 22

Container Corp. v. Franchise Tax Board, 463 *U.S.* 159 (1983) 17

Exxon Corp. v. Governor of Maryland, 437 *U.S.* 117 (1978) 20, 21, 22

Exxon Corp. v. Wisconsin Dept. of Revenue, 447 *U.S.* 207 (1980) 6, 12, 14, 16

Hans Rees' Sons v. North Carolina, ex rel. Maxwell, 283 *U.S.* 123 (1931) 13

Maryland v. Louisiana, 451 *U.S.* 725 (1981) 20

Mobil Oil Corp. v. Commissioner of Taxes, 445 *U.S.* 425 (1980) 12, 17

Moorman Mfg. Co. v. Bair, 437 *U.S.* 267 (1978) 13

Northwestern States Portland Cement Co. v. Minnesota, 358 *U.S.* 450 (1959) 12

Travis v. Yale & Towne Mfg. Co., 252 *U.S.* 60 (1920) 15

Underwood Typewriter Co. v. Chamberlain, 254 *U.S.* 113 (1920) 13

Werner Machine Co. v. Director, Division of Taxation, 350 *U.S.* 492 (1956) 3

Westinghouse Electric Corp. v. Tully, 466 *U.S.* 388 (1984) 16, 20

Wheeling Steel Corp. v. Glander, 337 *U.S.* 562 (1949) 22

TABLE OF AUTHORITIES—Continued

STATUTES

	Page
Federal	
Crude Oil Windfall Profit Tax Act of 1980, *P.L.* 96-223, 94 *Stat.* 229, 26 *U.S.C.* § 4986 *et seq.*, (*IRC* § 4986 *et seq*)	4
IRC § 243(a)	3
IRC § 263	19
IRC § 4986(a)	4, 5
IRC § 4987(b)	8
IRC § 4988(a)	5, 6
IRC § 4988(b)	5, 6
IRC § 4988(b) (1)	5
IRC § 4988(b) (3) (A)	5
IRC § 4988(b)(3)(B)	5
IRC § 4988(b)(3)(C)(i)(I)	5
IRC § 4988(c)(3)	5
IRC § 4989	5
IRC § 4990(c)	6
IRC § 4990(d)	7
IRC § 4991(d)	8
IRC § 4991(e)	8
IRC § 4996(c)(2)	6

TABLE OF AUTHORITIES—Continued

	Page
State	
N.J.S.A. 54:10A-1 *et seq.*	3
N.J.S.A. 54:10A-5(a)	3
N.J.S.A. 54:10A-5(c)	14
N.J.S.A. 54:10A-4(k)	14
N.J.S.A. 54:10A-4(k)(2)	19
N.J.S.A. 54:10A-4(k)(2)(C)	*passim*
N.J.S.A. 54:10A-4(k)(2)(E)	15, 19
N.J.S.A. 54:10A-4(k)(2)(F)(i)	19

REGULATIONS

Treas. Reg. § 1.613-3(a)	5
Treas. Reg. § 1.613-5(a)	5

LEGISLATIVE MATERIALS

Cong. Budget Office, "The Windfall Profits Tax: A Comparative Analysis of Two Bills," (Nov. 1979)	4
H.R. Rep. No. 304, 96th Cong., 1st Sess. (1979)	4, 5
S. Rep. No. 394, 96th Cong., 2nd Sess. (1979)	5, 8

MISCELLANEOUS

15 Weekly Comp., Pres Docs. (April 5, 1979)	4

No. 87-453

In The

Supreme Court of the United States

October Term, 1987

AMERADA HESS CORPORATION, *et al.*,

Appellants,

v.

DIRECTOR, DIVISION OF TAXATION,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF NEW JERSEY

MOTION OF APPELLEE TO DISMISS OR AFFIRM

Appellee Director, Division of Taxation respectfully moves pursuant to Rule 16(1)(b) and (d) to dismiss this appeal or to affirm the judgment of the Supreme Court of New Jersey because the issue presented does not raise a substantial federal question and because the decision below was manifestly correct.

COUNTERSTATEMENT

The 11 oil company appellants would have this Court set down for full briefing and argument their appeal from

a decision of the Supreme Court of New Jersey which, after holding as a matter of New Jersey law that appellants could not deduct the federal crude oil windfall profit tax ("WPT") in computing their New Jersey corporation business tax liabilities, concluded that denying the deduction violated no provision of the United States Constitution (App33a to App35a).[1] In rejecting appellants' Due Process Clause claim, the New Jersey Supreme Court reasoned that since the oil companies "are concededly unitary businesses," (App33a), New Jersey is entitled to include in the income measure of the corporation business tax 100% of each company's entire net income reduced by the standard three-factor apportionment formula to reflect each company's business activity in New Jersey (*ibid.*). Having determined as a matter of New Jersey law that the issue confronting the court was whether appellants are entitled to a deduction for the WPT, not whether a segment of their oil production income having an out-of-state source should be added to the base, the New Jersey court found no infringement of the territorial constraints of the Due Process Clause. The New Jersey Supreme Court held that there was no violation of either the Commerce Clause or Equal Protection Clause because denying a deduction for the WPT "does not favor in-state over out-of-state economic activity" (App34a), does not favor in-state over out-of-state companies or transactions, and indeed draws no distinction "based on the interstate nature of plaintiffs' businesses . . ." (*ibid.*). Reaching the companies' argument that they are discriminated against vis-a-vis non-oil

---

[1] "App." refers to the appendix to the jurisdictional statement.

producing petroleum marketers, the New Jersey court reasoned that these marketers do not pay the WPT and have not benefitted from the lifting of crude oil price controls as have the producer marketers. Hence the statute draws no invidious or irrational distinctions. The New Jersey court rejected appellants' Supremacy Clause argument (not pressed here) on the ground that there was no indication that accomplishment of federal energy or revenue policies would be thwarted by New Jersey's denial of a deduction for the WPT (App34a to App35a).

The New Jersey Corporation Business Tax Act (*N.J.S.A.* 54:10A-1 et seq.), which was construed by the Supreme Court of New Jersey to deny a deduction for the WPT, is a franchise tax, measured in the years before the Court (1980 and 1981) by the sum of a tax based on net income and a tax based on net worth.[2] *See Werner Machine Co. v. Director, Division of Taxation*, 350 *U.S.* 492 (1956). The income measure of the CBT is based on a corporation's taxable income for federal income tax purposes prior to net operating losses and special deductions (*e.g.* the dividends received deduction allowed by *IRC* § 243(a)), but this preliminary computation is modified to deny certain deductions allowed for federal income tax purposes. Among such disallowed deductions are "[t]axes paid or accrued to the United States on or measured by profits or income . . . " *N.J.S.A.* 54:10A-4(k)(2)(C) (A. App2a).[3] As construed by the Supreme Court of New Jer-

---

[2] The net worth measurement of the tax no longer exists as of taxable years beginning on or after July 1, 1986. *N.J.S.A.* 54:10A-5(a).

[3] "A. App." refers to the appendix to this motion to dismiss or affirm.

sey, this provision denies a deduction for the WPT, and it is this provision that, according to appellants, violates their constitutional rights.

The Crude Oil Windfall Profit Tax Act of 1980, *P.L.* 96-223, 94 *Stat.* 229, 26 *U.S.C.* § 4986 *et seq.* (*IRC* § 4986 *et seq.*) was enacted as part of the Carter Administration's program to decontrol the price of crude oil. The tax was perceived by the Administration and its drafters as a tax on the unearned wellhead profits of oil producers resulting purely from increases in the controlled price of crude oil (which ranged at that time from approximately $6 to $13 per barrel) to the uncontrolled price (which was then approximately $20 per barrel). *H.R. Rep.* No. 304, 96th Cong., 1st Sess. 5, 6 (1979). As stated by the President:

> I want to emphasize that this Windfall Profits Tax is not a tax on the American people. It is purely and simply a tax on the new profits of the oil producers which they will receive but not earn [15 Weekly Comp., Pres. Docs. 611 (April 5, 1979)].

In the words of the Congressional Budget Office, the principal purpose of the tax was to "capture a larger portion of the additional producer revenues than would be taxed through the existing corporate income tax" and to reach the "unanticipated profits arising from decontrol or increases in world prices." Cong. Budget Office, "The Windfall Profits Tax: A Comparative Analysis of Two Bills," 1 (Nov. 1979).

Since the purpose of the tax is to capture increased profits attributable to the decontrol of crude oil prices, the tax is imposed on wellhead profit or income rather than on the ultimate sale of refined crude oil and petro-

chemical products. Accordingly, the basic measurement of the tax is the difference between the uncontrolled price ("removal price") and the controlled price ("adjusted base price") of a barrel of crude oil when the oil is removed from a producing property. *IRC* § 4988(a); *IRC* § 4989. In the case of integrated oil companies such as the appellants, removal of oil from a producing property may not correspond with a sale or exchange of the oil to a third party, in which case the constructive sales price (generally the posted price of oil in the particular field) is substituted for the sales price in determining the uncontrolled or removal price of the oil. *IRC* § 4988(c)(3); *Treas. Reg.* § 1.613-3(a). This difference between the controlled and uncontrolled price is the windfall profit (*IRC* § 4988(a)) on which the tax is imposed. *IRC* § 4986(a).

To ensure that the WPT is not imposed when there is no profit, *i.e.*, when the cost of producing oil exceeds its price, Congress enacted an alternative base for the tax—the net income limitation. *IRC* § 4988(b); *H.R. Rep.* No. 304, 96th Cong., 1st Sess., 2 (1979); *S.Rep.* No. 394, 96th Cong., 2nd Sess., 29 (1979). Under *IRC* § 4988(b)(1) the windfall profit cannot exceed 90% of the net income per barrel. In determining its net income for purposes of the limitation, a producer is entitled to deduct all its expenses incurred in producing the oil. *IRC* § 4988(b)(3)(A); *Treas. Reg.* § 1.613-5(a).[4] As a result of the net income

[4] Certain preferential deductions allowed for federal income tax purposes under certain circumstances, including percentage depletion and intangible drilling costs, are not allowed in determining taxable income for purposes of the net income limitation. *IRC* § 4988(b)(3)(B). Cost depletion, however, is allowed, and amounts which would otherwise be deducted as intangible drilling costs are included in the depletable cost base and allowed over time in the form of cost depletion. *IRC* § 4988(b)(3)(C)(i)(1).

limitation, the windfall profit is always net of a producer's cost to produce a barrel of oil. In fact, in many instances the WPT allows for the deduction of more than actual costs because in every case where the controlled price exceeds actual costs, a producer deducts the higher amount in the form of the adjusted base price. *IRC* § 4988(a) and *IRC* § 4988(b). To paraphrase *N.J.S.A.* 54:10A-4(k)(2)(C), the windfall profit tax is a tax paid or accrued to the United States on or measured by the windfall profit or the net income per barrel.

The WPT is not a severance tax because its base is not the market value of oil at the wellhead nor the quantity of production. *See IRC* § 4996(c)(2) defining the term "severance tax" for purposes of the WPT and *Exxon Corp. v. Wisconsin Dept. of Revenue,* 447 *U.S.* 207, 228, n. 12 (1980). The base of the WPT allows a deduction from the market value of the oil for the greater of the adjusted base price or a producer's actual costs. As stated by the New Jersey Supreme Court, "The windfall profit cannot be equated with the market value of oil; it is a net amount, not simply the sales price, as in the case of federal transactional excise taxes" (App17a).

The WPT is a temporary tax. It is to be phased out over a 33-month period beginning no later than December 1990. *IRC* § 4990(e).

Certain false impressions produced by the jurisdictional statement should be briefly noted. First, the Supreme Court of New Jersey's construction of the CBT does not "preclude . . . a deduction for the billions of dollars in WPT payments that appellants and others have made to the federal government since 1980" (J.S. 3).[5] Rather, by reason of the application of the three-factor apportionment formula, only a small fraction of each company's WPT payments is disallowed. Second, whether WPT payments are correctly treated as inventoriable production costs and thus part of cost of goods sold for federal income tax purposes (*cf.* J.S 6) is unclear, (*see* Joint brief for defendant-respondent Director, Division of Taxation, Superior Court of New Jersey, Appellate Division, Docket No. A-2795-84 T7 *et seq.* at 55 to 57), but what is clear is that certain of these appellants in fact treated the WPT as a tax expense, not an inventoriable production cost. (Appellate Division joint appendix for plaintiffs-appellants 1289a, 1305a, 1307a). Thus, the WPT was not an item of cost of goods sold for at least some of the appellants. Third, to the extent that Congress may have assumed that the WPT would in general be deductible for State tax purposes (J.S. 7), that assumption appears only in the House and Senate reports (*ibid.*) and only in connection with estimating the revenue effect of the tax. As shown by the fact that the WPT will begin to phase out no later than January 1991 whether or not net windfall revenues reach $227.3 billion (*IRC* § 4990(c); *IRC* § 4990(d)), the revenue estimate was not an essential element of the legislation. Moreover, there was no connection whatever in Congress' mind between the deductibility of the WPT for state tax purposes and the accomplishment of federal energy policies. The WPT may have been crafted so as not to create undue production disincentives, but this tailoring of the Act did not include an assumption that the

[5] "J.S." refers to the jurisdictional statement.

WPT would be deductible for state tax purposes. As stated in the Senate Report:

> [The Committee] believes that any such tax should be structured carefully to eliminate as much as possible, adverse effects on domestic production. For this reason the committee substitute contains several exemptions from the tax for types of oil whose production it believes to be especially responsive to more lenient tax treatment, such as newly discovered oil, tertiary oil, stripper oil and heavy oil.[6] [*S. Rep.* No. 96-394, 96th Cong., 2nd Sess. 6 (1979)].

Appellants persist throughout the jurisdictional statement in labeling *N.J.S.A.* 54:10A-4(k)(2)(C) an "add-back" provision. The New Jersey Supreme Court, however, flatly rejected this characterization, concluding as a matter of state law that the provision at issue denies a deduction in determining entire net income (App12a). Appellants are precluded in this Court from rearguing the state law question decided against them by the Supreme Court of New Jersey.

Attempting to lay the foundation for an argument that this case presents a substantial question, appellants advise that, "Many State tax schemes employ comparable add-back provisions" (J.S. 8). With the exception of the New York franchise tax, however, there are few, if any, state taxes which employ language identical to New Jersey's CBT. *See* App85a to App91a). Whether the differing language in these other statutes could be construed

---

[6] *See* e.g., *IRC* § 4987(b), *IRC* § 4991(d) and *IRC* § 4991(e), imposing lower tax rates on newly discovered, tertiary, stripper, and heavy oil.

to deny a deduction for the WPT is an open question. Finally, appellants' statement (J.S. 11) that the New Jersey Supreme Court failed to address their argument that they are discriminated against vis-a-vis independent marketers is simply untrue. The court responded to this argument in rejecting appellants' claim under the Equal Protection Clause (App34a), and appellants themselves argued in the courts below that "cases striking down State taxes because of their discriminatory impact on interstate commerce also rely upon the Equal Protection Clause . . ." (Joint brief on behalf of plaintiffs-appellants, Superior Court of New Jersey, Appellate Division, Docket No. A-2795-84T7 *et seq.* at 72).

ARGUMENT

POINT I

PLENARY REVIEW IS NOT WARRANTED BECAUSE THE QUESTION IS NOT SUBSTANTIAL.

The issue of whether New Jersey can constitutionally deny a deduction for the WPT under its corporate franchise tax is not substantial. The New Jersey statutory language—"taxes paid or accrued to the United States on or measured by profits or income . . ." (*N.J.S.A.* 54:10A-4(k)(2)(C)) is unobjectionable on its face and when applied to most federal taxes. Even if appellants were correct that the statute is unconstitutional when applied to them, a decision by this Court to that effect would do no more than prohibit the application of the statutory

provision to a particular set of facts, *i.e.*, where the federal tax is referenced to an out-of-state activity. Similar disallowance provisions in other state corporation taxes, as well as *N.J.S.A.* 54:10A-4(k)(2)(C) itself, would continue in force. A later case seeking the Court's review of a similar disallowance provision would involve a different set of facts, such that a decision in this case would not necessarily control the outcome. Any principle announced in this case, were the Court to accept it for plenary review, would establish nothing more than the invalidity of *N.J.S.A.* 54:10A-4(k)(2)(C) when applied to a unique set of facts.

Moreover, the decision of the Supreme Court of New Jersey denying a deduction for the WPT does not have national ramifications, either from the perspective of the revenue involved or the decision's effect on other States. While crude oil producers may have paid more than $78 billion in WPT to the federal government (J.S. 13), the amounts paid by these appellants to New Jersey are small by comparison since in every case the three-factor apportionment formula greatly reduces each appellant's entire net income taxable in New Jersey. *See* App84a showing total WPT payments by these appellants for the years at issue in this litigation of approximately $20.5 million.[7] Additionally, following the worldwide drop in crude oil prices, beginning in 1982, New Jersey's CBT receipts attributable to denying a deduction for the WPT have steadily decreased.[8] On the national scene, according to appellants, only six States in addition to New Jersey presently disallow the deduction (J.S. 14). Of these six, only Minnesota and Wisconsin expressly deny a deduction for the tax, while, with the exception of New York, every other State's generic denial of a deduction for certain federal taxes is phrased differently from New Jersey's. Whether these differently worded disallowance provisions could be construed to apply to the WPT under the New Jersey Supreme Court's opinion is unclear. The likelihood of other States' amending their corporation taxes to specifically deny a deduction for the WPT is slight. Potential state revenue to be gained from denying the deduction has decreased due to the worldwide drop in crude oil prices, and the potential revenue source is of temporary duration because the WPT will begin to phase out no later than January 1991. In light of the temporary nature of the WPT, the decline in revenues which can be anticipated from denying a deduction for the tax, and the dissimilarity in other States' statutory language, it is unlikely that the opinion of the Supreme Court of New Jersey will encourage other

---

7 Even with the addition of $78 million attributable to denying a deduction for the WPT through 1984 (J.S. 14), New Jersey's revenue gains are minute by comparison to total WPT paid to the federal government.

---

8 The records of the New Jersey Division of Taxation show the following approximate revenues attributable to denying a deduction for the WPT to these and other producers of crude oil through the 1984 taxable year:

1980	$ 10.7 million
1981	36.7 "
1982	19.8 "
1983	12.9 "
1984	8.4 "
Total	$ 88.5 million

(The figures do not include deficiency interest.)

States to enact similar disallowances or to interpret their corporation taxes in a similar fashion.

In addition to the fact that an opinion by this Court after plenary review would not establish a significant principle of constitutional law nor have nationwide importance, appellants' claim of geographic distortion (J.S. 11 to J.S. 13) has been dealt with already, albeit in a slightly different form, in *Exxon Corp. v. Wisconsin Dept. of Revenue, supra.*

The Court has repeatedly stated that "the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs." *Northwestern States Portland Cement Co. v. Minnesota*, 358 *U.S.* 450, 460 (1959); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 *U.S.* 425, 436 (1980); *Exxon Corp. v. Wisconsin Dept. of Revenue, supra,* at 219. Both the Due Process Clause of the Fourteenth Amendment and the comparable requirements of the Commerce Clause are satisfied if there is a sufficient connection between "the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.' " *Mobil Oil Corp. v. Commissioner of Taxes, supra* at 436-37; *Exxon Corp. v. Wisconsin Dept. of Revenue, supra* at 219-20. If a business is found to be unitary, the taxing State has a sufficient connection with a multistate corporation's activities to tax its entire net income even though a portion of that income may have its geographic source outside the State. *Exxon Corp. v. Wisconsin Dept. of Revenue, supra* at 220-21, 223. As the Supreme Court of New Jersey

pointed out, appellants "are concededly unitary businesses" (App33a). Appellants concededly do business in New Jersey (J.S. 3). Accordingly, there is a sufficient connection between New Jersey and appellants' interstate activities to permit New Jersey to subject appellants' entire net income to tax without violating the nexus requirement of either the Due Process or Commerce Clause.

In only one case involving a unitary business has the Court found that the *quantum* of income subjected to a state tax violated the further requirement of the Due Process Clause that there be a rational relationship between the income attributed to the State and the intrastate values of the enterprise. In *Hans Rees' Sons v. North Carolina, ex rel. Maxwell*, 283 *U.S.* 123 (1931), the Court concluded that the taxpayer had established by clear and cogent evidence that formula apportionment resulted in a tax on approximately 80% of the corporation's income while only 17% of the income had its actual source in the taxing State. In other cases, taxpayer claims that formulary apportionment violates the Constitution by subjecting too much of their income to tax have met with no success. *See Underwood Typewriter Co. v. Chamberlain*, 254 *U.S.* 113 (1920); *Moorman Mfg. Co. v. Bair*, 437 *U.S.* 267 (1978). While obviously dealing with state tax apportionment formulas and not the computation of net income, these apportionment cases nevertheless demonstrate that, once beyond the nexus requirement of the Due Process and Commerce Clauses, taxpayers must conclusively demonstrate the most severe distortion of income in order to obtain relief from a state taxing scheme. Short of this, the requirement of the Due Process and Commerce Clauses

that there be a rational relationship between the amount of income taxed and the in-state activities of the business is satisfied.

Appellants do not even attempt to establish that New Jersey's denial of a deduction for the WPT results in an irrational, arbitrary *amount* of their income being subjected to tax. Instead, they suggest that the mere fact that the production of crude oil takes place outside New Jersey, combined with New Jersey's disallowance of a deduction for a cost associated with that production, results in a "material geographic bias" (J.S. 12) in the net income base. There is no such bias. The tax base of the New Jersey corporation business tax is entire net income with certain adjustments. *N.J.S.A.* 54:10A-5(c); *N.J.S.A.* 54:10A-4(k). Entire net income (prior to the statutory adjustments) is deemed to be federal taxable income prior to the net operating loss deduction and special deductions. *N.J.S.A.* 54:10A-4(k). Federal taxable income, in turn, derives from appellants' gross receipts and other income, realized throughout their integrated petroleum businesses. *See* App33a. New Jersey's denial of a deduction for a cost which happens to have a geographic source outside the States does not distort the base to any greater degree than does inclusion of income from a non New Jersey source. Since appellants are unitary businesses, neither the inclusion of their oil production income as sanctioned in *Exxon Corp. v. Wisconsin Dept. of Revenue, supra,* nor the denial of a deduction attributable to oil production interjects an unconstitutional geographic bias into the net income base. Unless appellants can establish that something other than income from their integrated petroleum enterprises is being taxed,

New Jersey's denial of a deduction for the WPT introduces no unconstitutional distortion to the net income base of the CBT.

Aside from the fact that it has no legitimate constitutional source, appellants' theory of geographic distortion, if accepted, would be unworkable. Every deduction a State chose to disallow in determining the net income of a unitary business would have to be scrutinized to determine whether the disallowed cost related to an out-of-state activity. For instance, under the New Jersey CBT, another of the federal income tax deductions disallowed in computing entire net income is a portion of interest paid to 10% or more shareholders. *N.J.S.A.* 54:10A-4(k)(2)(E) (*see* A. App2a). Under appellants' theory, this provision could not be applied where both the debt and the 10% or more shareholder were located outside New Jersey. Under appellants' theory, while New Jersey would be precluded from denying a deduction for the WPT, New York, which has a virtually identical disallowance provision in its franchise tax (*see* App88a), could constitutionally deny the deduction because the State has minimal crude oil production within its borders (J.S. 15, n.12). Finally, no State could deny a deduction for real property taxes, despite state fiscal exigencies, unless the property were located in-state. The Constitution surely is not meant to restrict in this fashion the States' ability to raise revenue to support their sovereign governments. The one exception would be a disallowance provision aimed at nonresidents *qua* nonresidents, such as the provision at issue in *Travis v. Yale & Towne Mfg. Co.*, 252 *U.S.* 60, 79 (1920), which denied personal exemptions under a state personal income tax to nonresidents while allowing them

to residents. The New York franchise tax provision at issue in *Westinghouse Electric Corp. v. Tully*, 466 *U.S.* 388 (1984), was similar in nature, allowing a tax credit which increased in direct proportion to a taxpayer's shipments from New York ports. Here, to the contrary, New Jersey is neither disadvantaging nonresidents as such nor providing tax benefits for economic activity within the State. Accordingly, appellants' arguments to the contrary notwithstanding (J.S. 17), there is no suspicious tailoring of the CBT to the disadvantage of nonresidents or out-of-state economic activity.

In sum, appellants' geographic distortion argument is nothing more than a remodel of Exxon's argument in *Exxon Corp. v. Wisconsin Dept. of Revenue, supra*, and appellants' attempt to inflate the issue to one of national importance is transparent. As the Tax Court of New Jersey remarked three years ago, "This is a case of statutory construction" (App43a). The federal question is not substantial.

POINT II

PLENARY REVIEW IS NOT WARRANTED BECAUSE THE SUPREME COURT OF NEW JERSEY CORRECTLY REJECTED APPELLANTS' CLAIMS THAT DENIAL OF A DEDUCTION FOR THE WINDFALL PROFIT TAX IMPOSES NEW JERSEY'S CORPORATION BUSINESS TAX ON EXTRATERRITORIAL VALUES AND DISCRIMINATES AGAINST INTERSTATE COMMERCE.

Denial of a deduction for the WPT does not result in the corporation business tax being unfairly apportioned. The crux of appellants' argument, as made clear at p.20

of their jurisdictional statement, is that by denying a deduction for the WPT, New Jersey is taxing too much of their income. As demonstrated above in Point I, however, taxpayers claiming that a state tax bears too heavily on a unitary business have an extremely difficult burden of proof. The fundamental concept underlying the unitary business principle is that it is impossible to separately account for the profitability of each segment of such a business.

> [S]eparate accounting, while is purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. [*Mobil Oil Corp. v. Commissioner of Taxes, supra* at 438].

Appellants, which are concededly unitary businesses, have not demonstrated or even attempted to demonstrate what portion of their income should properly be attributed to New Jersey. They thus have not demonstrated that denying a deduction for the WPT attributes too much of their net income to the State. *See Container Corp. v. Franchise Tax Board*, 463 *U.S.* 159, 182 (1983).

Appellants suggest that denial of a deduction for a cost associated with an out-of-state activity is the equivalent of doubling the income from an out-of-state activity (J.S. 19). Appellants overlook the fact that the CBT is based upon federal taxable income, which in turn is derived from each of these appellants' realized gross receipts. Denying a deduction for the WPT may increase the amount of each appellant's taxable income, but it is not equivalent to adding gross receipts to the tax base. A simple example illustrates the difference. Assume that

one of the appellants had gross receipts of \$100, deductions including the WPT of \$91, and deductions not including the WPT of \$90. The appellants' and New Jersey's positions are shown schematically as follows:

	Appellants	*New Jersey*
Gross receipts	\$100	\$100
Deductions including WPT	\$ 91	
Deductions not including WPT		\$ 90
Entire net income	\$ 9	\$ 10

Denying a deduction for the WPT does not add an item of gross receipts to the tax base, which remain \$100 in both cases. The Supreme Court of New Jersey rejected appellants' argument that denying a deduction for the WPT is equivalent to including an additional item of income (App33a).

Appellants' next argument that denial of a deduction for the WPT is tantamount to New Jersey's imposing its own WPT (J.S. 20 to J.S. 24) is frivolous. The argument rests on the premise that *N.J.S.A.* 54:10A-4(k)(2)(C) adds an item of gross receipts to the CBT base and imposes a tax on the "add-back." Appellants again overlook the fact that the Supreme Court of New Jersey construed the provision as one disallowing a deduction (App12a). As a matter of state law, appellants are thus foreclosed from arguing in this Court that *N.J.S.A.* 54:10A-4(k)(2)(C) is an "add-back" provision. Moreover, as made clear by the example in the preceding paragraph, denying a deduction for the WPT is not the tax equivalent of New Jersey's imposing its own WPT. The tax base of the CBT is realized gross receipts less certain deductions. Whether the WPT is allowed or disallowed affects the amount of net

income to be included in the base, but the base remains appellants' gross receipts from the sale of petroleum products less certain deductions. In taxing more or less of appellants' net income, New Jersey is not reaching out to tax values outside its borders in the form of imposing its own WPT. Rather, it is taxing an apportioned share of these appellants' unitary net business income. Since appellants are unitary businesses, New Jersey is entitled to tax such apportioned share even though a portion of the income has its geographic source in other States.

If appellants were correct that denying a deduction was tantamount to taxing the disallowed item, the theory would create extraordinary tax anomalies. The other adjustments in *N.J.S.A.* 54:10A-4(k)(2) include the disallowance of a deduction for 90% of interest paid on debt to 10% or more shareholders (*N.J.S.A.* 54:10A-4(k)(2)(E)) and the disallowance of a deduction for the excess of federal accelerated cost recovery system depreciation over depreciation computed according to pre-1981 federal income tax methods. *N.J.S.A.* 54:10A-4(k)(2)(F)(i). (A. App3a). If the appellants were correct in their theory, the disallowance of these deductions would mean that the CBT is imposed upon interest paid out and depreciation claimed. Under appellants' theory the federal income tax disallowance of a deduction for capital expenditures (*IRC* § 263) would mean that the federal government is taxing capital.

In short, denial of a deduction for the WPT does not unconstitutionally tax extraterritorial values. Rather, the effect of the disallowance is simply to augment appellants' entire net income, all of which is subject to the CBT because appellants are unitary businesses.

Appellants' final argument (J.S. 24 to J.S. 30) is that denying them a deduction for the WPT discriminates against interstate commerce because the denial has the effect of imposing a greater tax liability on account of their out-of-state activities, namely the production of crude oil. Plaintiffs' argument is doomed to fail under *Exxon Corp. v. Governor of Maryland*, 437 *U.S.* 117 (1978).

The Commerce Clause prohibits a State from taxing transactions involving interstate commerce more heavily than transactions not involving such commerce (*Boston Stock Exchange v. State Tax Commission*, 429 *U.S.* 318 (1977)), from drawing distinctions between interstate transactions in ways which favor local commercial interests (*Westinghouse Electric Corp. v. Tully, supra*), and from structuring its taxes in ways which favor in-state consumers at the expense of out-of-state consumers. *Maryland v. Louisiana*, 451 *U.S.* 725 (1981). No such distinction between in-state and out-of-state interests results from the denial of a deduction for the WPT.

In denying a deduction for "taxes paid or accrued to the United States on or measured by profits or income . . . ," *N.J.S.A.* 54:10A-4(k)(2)(C) is plainly not aimed at out-of-state transactions, businesses, activities, or consumers. The provision is thus entirely unlike the aspects of the New York stock transfer tax which provided tax benefits for transactions on New York exchanges (*Boston Stock Exchange v. State Tax Commission, supra*), and for the same reason is totally unlike the provision in the New York franchise tax which increased a corporation's D.I.S.C. credit to the extent the corporation's products were shipped from New York ports. *Westinghouse House Electric Corp. v. Tully, supra*. As appellants properly concede, *N.J.S.A.* 54:10A-4(k)(2)(C) does not favor in-state economic activity because, since there is no crude oil production in New Jersey (J.S. 26), there is no in-state acivity to be favored.

Appellants suggest that the provision nevertheless violates the Commerce Clause because it "single[s] out for special tax burdens a form of business activity that is conducted only in other jurisdictions" (*ibid*). But that argument is foreclosed by *Exxon Corp. v. Governor of Maryland, supra* and *Commonwealth Edison Co. v. Montana*, 453 *U.S.* 609 (1981). In the former case, the Court sustained a Maryland statute which prohibited a producer or refiner of petroleum products from operating a retail service station within the State. Since all of Exxon's gas which was sold in Maryland was both refined and produced outside the State, the regulation had the same effect as New Jersey's denial of a deduction for the WPT—in appellants' terms, it "singled out for special . . . burdens a form of business activity that is conducted only in other jurisdictions" (J.S. 26). Like appellants here who argue that they are discriminated against vis-a-vis nonproducer marketers which purchase their crude oil and can therefore deduct the equivalent of the WPT in their cost of goods sold, Exxon argued that the Maryland regulation burdened it while protecting Maryland independent dealers. The answer to appellants' argument here is the same as it was in the Maryland case. Some of the nonproducer marketers against whom appellants allegedly compete engage in interstate commerce just as do appellants. Consequently, the denial does not favor the in-state market at the expense of the interstate market or interstate firms. As aptly stated by the Supreme Court of New Jersey, the

distinction drawn by the application of *N.J.S.A.* 54:10A-4(k)(2)(C) to the WPT is between companies which produce crude oil and those which do not (App34a). Since the distinction does not depend on the interstate nature of appellants' businesses, there is no violation of the Commerce Clause.

Although *Exxon Corp. v. Governor of Maryland, supra* involved a state regulatory measure, the same analysis applies to a state tax. As made clear by *Commonwealth Edison Co. v. Montana, supra,* the Constitution does not prohibit a State from singling out for special tax treatment particular industries carrying on business within it. If Montana could impose a severance tax on the mining of low sulphur coal, New Jersey can deny a deduction for the WPT incurred by producers of crude oil. The mere fact that a particular tax bears more heavily on one industry than on others does not in itself establish discrimination against interstate commerce. Like Montana's coal severance tax, New Jersey's denial of a deduction for the WPT draws no distinctions based on state lines. *See* 453 *U.S.* at 618. The " 'adventitious consideration . . .' " that Montana may have a monopoly with respect to low sulphur coal is qualitatively no different for purposes of determining whether a state tax discriminates against interstate commerce than the absence of oil reserves in New Jersey.

In terms of the Equal Protection Clause, appellants are not similarly situated to marketers who do not produce crude oil, and thus the statute draws a legitimate distinction between the two classes. *See Wheeling Steel Corp. v. Glander,* 337 *U.S.* 562, 572 (1949). Further, as the Supreme Court of New Jersey correctly pointed out,

nonproducer marketers did not benefit from the decontrol of crude oil prices as did integrated producer marketers such as appellants. Instead, nonproducer marketers were forced to pay the higher unregulated price to obtain their supplies of crude oil (App34a).

In summary, denial of a deduction for the WPT neither discriminates against interstate commerce in violation of the Commerce Clause nor violates the Equal Protection Clause because the denial does not disadvantage nonresidents, out-of-state transactions, nor out-of-state consumers to the benefit of residents, in-state transactions, or in-state consumers.

CONCLUSION

For the foregoing reasons, the appeal should be dismissed, or the judgment of the Supreme Court of New Jersey should be affirmed.

Respectfully submitted,

W. Cary Edwards
Attorney General of New Jersey
Attorney for Appellee

By: Mary R. Hamill
Deputy Attorney General
(Counsel of Record)
Division of Law
Hughes Justice Complex
CN 112
Trenton, New Jersey 08625
(609) 292-1526

James J. Ciancia
Assistant Attorney General
(Of Counsel)

DATED: October 21, 1987

APPENDIX

Statute Involved

NEW JERSEY CORPORATION BUSINESS TAX ACT

§ 54:10A-4. Definitions

For the purposes of this act, unless the context requires a different meaning:

. . . .

(k) "Entire net income" shall mean total net income from all sources, whether within or without the United States, and shall include the gain derived from the employment of capital or labor, or from both combined, as well as profit gained through a sale or conversion of capital assets. For the purpose of this act, the amount of a taxpayer's entire net income shall be deemed prima facie to be equal in amount to the taxable income, before net operating loss deduction and special deductions, which the taxpayer is required to report to the United States Treasury Department for the purpose of computing its federal income tax; provided, however, that in the determination of such entire net income,

. . . .

(2) Entire net income shall be determined without the exclusion, deduction or credit of:

(A) The amount of any specific exemption or credit allowed in any law of the United States imposing any tax on or measured by the income of corporations;

(B) Any part of any income from dividends or interest on any kind of stock, securities or indebtedness, except as provided in paragraph (5) of subsection (k) of this section;

(C) Taxes paid or accrued to the United States on or measured by profits or income, or the tax imposed by this act, or any tax paid or accrued with respect to subsidiary dividends excluded from entire net income as provided in paragraph (5) of subsection (k) of this section;

(D) (Deleted by amendment, P.L.1985, c. 143);

(E) 90% of interest on indebtedness owing directly or indirectly to holders of 10% or more of the aggregate outstanding shares of the taxpayer's capital stock of all classes; except that such interest may, in any event, be deducted

(i) Up to an amount not exceeding $1,000.00;

(ii) In full to the extent that it relates to bonds or other evidences of indebtedness issued, with stock, pursuant to a bona fide plan of reorganization, to persons who, prior to such reorganization, were bona fide creditors of the corporation or its predecessors, but were not stockholders or shareholders thereof;

(iii) In full to the extent that it relates to debt of a financial business corporation owed to an affiliate corporation; provided that such interest rate does not exceed 2% over prime rate; the prime rate to be determined by the Commissioner of Banking;

(iv) In full to the extent that it relates to financing of motor vehicle inventory held for sale to customers; provided said indebtedness is owed to a taxpayer customarily and routinely providing this type of financing;

(v) In full to the extent it relates to debt of a banking corporation to a bank holding company, of which the banking corporation is a subsidiary, or to a debt of a banking corporation to another banking corporation with respect to federal funds transactions governed by section 23A of the Federal Reserve Act (12 U.S.C. § 371c.) when both banking corporation are subsidiaries of the same bank holding company, as defined in 12 U.S.C. § 1841.

(F)(i) The amount by which depreciation reported to the United States Treasury Department for property placed in service on and after January 1, 1981, for purposes of computing federal taxable income in accordance with section 168 of the Internal Revenue Code [footnote omitted] in effect after December 31, 1980, exceeds the amount of depreciation determined in accordance with the Internal Revenue Code provisions in effect prior to January 1, 1981, but only with respect to a taxpayer's accounting period ending after December 31, 1981; provided, however, that where a taxpayer's accounting period begins in 1981 and ends in 1982, no modification shall be required with respect to this paragraph (F) for the report filed for such period with respect to property placed in service during that part of the accounting period which occurs in 1981.

(ii) For the periods set forth in subparagraph (F)(i) of this subsection, any amount, except with respect to qualified mass communting vehicles as described in section 168(f)(8)(D)(v) of the Internal Revenue Code as in effect immediately prior to January 1, 1984, which the taxpayer claimed as a deduction in computing federal income tax pursuant to a qualified lease agreement under paragraph (8) of that section.

The director shall promulgate rules and regulations necessary to carry out the provisions of this section, which rules shall provide, among others, the manner in which the remaining life of property shall be reported.